SUMMARY

This study measures changes in the distribution of combined federal tax liabilities by family income classes for three representative years during the 1975-1990 period. The years chosen for analysis were 1977, 1984, and 1988. The two historical years were years of relatively high growth in gross national product, declining unemployment rates, and rising but relatively modest rates of inflation. The years chosen are separated by important changes in federal tax laws. In 1977, the Tax Reform Act of 1978 and the Economic Recovery Tax Act of 1981 had not yet been enacted. By 1984, those changes were in place, but payroll tax increases enacted in 1983 and the Tax Reform Act of 1986 were yet to come. By 1988, most changes from the 1986 act will be in place.

Between 1977 and 1984, the distribution of total federal taxes became less progressive. This change primarily reflected a shift in the tax burden at both extremes of the income distribution. Effective tax rates (the ratio of taxes to family income) rose for the 10 percent of families at the lowest end of the distribution and fell for the 10 percent of families at the highest. Between 1984 and 1988, the distribution of taxes is expected to become more progressive but to remain less progressive than in 1977.

MEASURING FAMILY INCOMES AND FEDERAL TAX LIABILITIES

The results of this study necessarily depend on assumptions that are subject to challenge. There is no definitive way in which to assign combined federal taxes to particular family income groups. Neither is there a definitive way in which to measure family incomes. Both require methodological judgments and compromises that bear critically on the results obtained.

In this study, combined federal taxes include individual and corporate income taxes, social insurance payroll taxes, and excise taxes except for the windfall profit tax. The distribution of taxes is classified as progressive if the ratio of taxes to incomes (the effective tax rate) rises as incomes rise, regressive if the ratio of taxes to incomes falls as incomes rise, or proportional if the ratio is the same at all income levels.

Although federal tax payments are made by individuals, corporations, and other employers, the economic burden of all taxes ultimately rests with families and individuals. Economists speak of the reduction in family income or purchasing power as the incidence of a tax. The incidence of some taxes, particularly the corporate income tax, has not been estimated conclusively, and remains a controversial issue. The following incidence assumptions are used in the study.

- The individual income tax burden is attributed to the families who directly pay the tax. The tax does not shift among families.

- The social insurance payroll tax burden is allocated to employee compensation.

- The corporate income tax burden is allocated in two different ways. In alternative one, the burden is allocated to capital income. This is the standard treatment if the supply of investment capital is fixed, as in an economy where the rate of savings is relatively fixed and domestic capital markets are isolated from international markets. In alternative two, the burden is allocated to employee compensation. This is an appropriate treatment if the supply of investment capital is highly responsive to taxes and other prices, as in a world economy with interdependent capital markets. Because capital income is a larger share of the total income of higher-income families than of moderate- and lower-income families, the corporate tax is more progressive with the first alternative than the second.

- The excise tax burden is allocated in proportion to expenditures on the taxed goods and services.

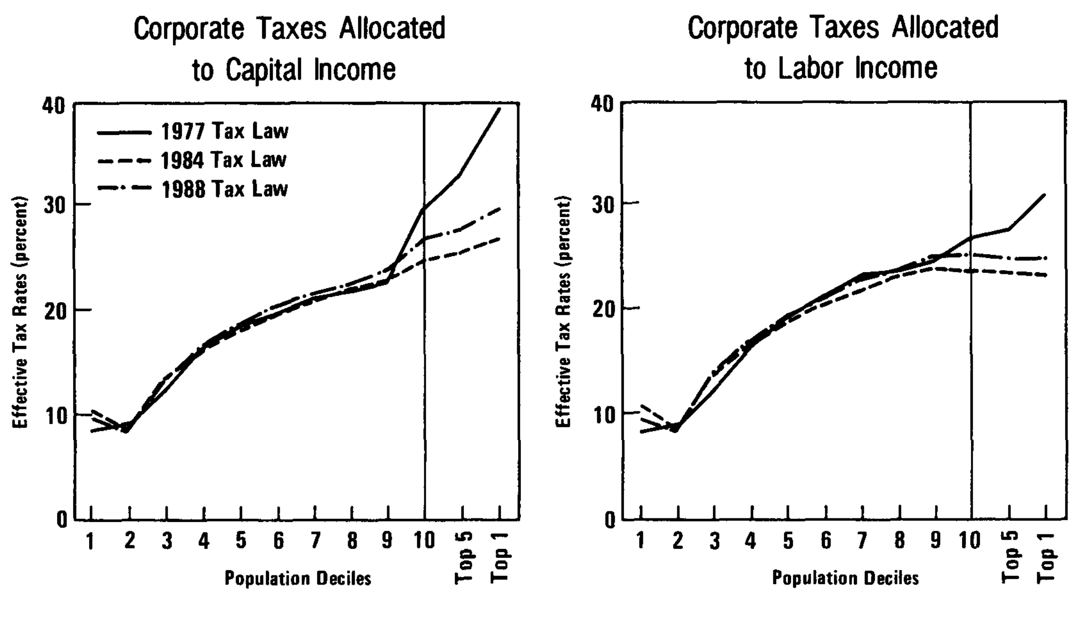
The study does not attempt to allocate the distributional effects of general government spending. In comparing the distribution of federal taxes in different years, shifts in the distribution of expenditures between those years are ignored. The study separates the distributional effects of taxes from the effects of expenditures specifically related to those taxes. Social Security revenues are thus implicitly treated as independent of benefit payments.

In the study, family income is measured on a cash receipts basis, a definition generally consistent with the measure of income used by the federal tax system. Family income equals the sum of wages, salaries, self-employment income, and personal rents, interest, and dividends, plus cash pension benefits and realized capital gains. Family income excludes accrued but unrealized capital gains, employer contributions to pension funds, in-kind government transfer payments, and other noncash income. Because income is measured before reductions for any federal taxes, contributions for federal social insurance and federal corporate profits taxes are added to family income.

CHANGES IN EFFECTIVE TAX RATES

Summary Figure 1 compares effective tax rates in 1977, 1984, and 1988. For most income deciles, the change in effective tax rates between 1977 and 1984 was relatively small. For families in the

Summary Figure 1.
Effective Federal Tax Rates by Population Decile (All taxes combined)



SOURCE: Congressional Budget Office tax simulation models.
NOTE: Families are ranked by the size of family income. Because family income includes the family's share of the corporate income tax, the ordering of families depends on the allocation of corporate taxes. The lowest decile excludes families with zero or negative incomes.
The effective tax rate is the ratio of taxes to family income in each income class.

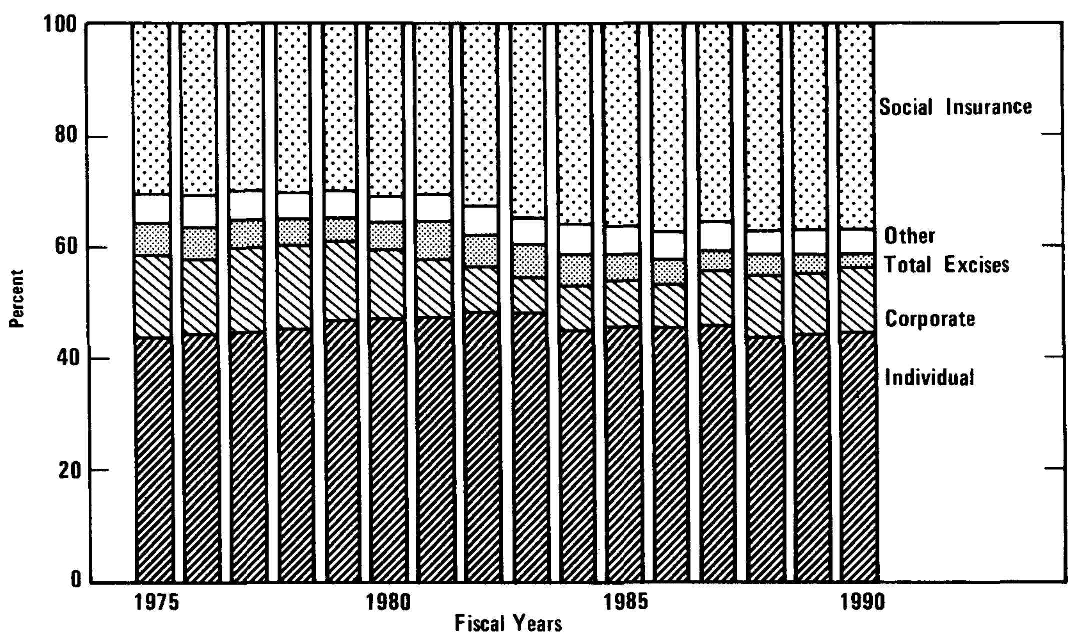
lowest decile, however, the total effective tax rate increased from 8 percent to 10.5 percent. The effective tax rate for families in the highest-income decile declined by just under five percentage points for the capital income allocation of the corporate tax and by three percentage points for the labor income allocation. For families in the top 1 percent of the income distribution, the total effective tax rate declined by about twelve percentage points when the corporate tax was allocated to capital income and by about eight percentage points when it was allocated to labor income.

By 1988, the effective tax rate for families in the lowest- income decile will decline slightly from its 1984 level, but will remain about 1.5 percentage points higher than in 1977. Between 1984 and 1988, the rate for families in the highest-income decile will increase by 1.4 to 1.8 percentage points depending on the allocation of the corporate income tax, but will remain two to three percentage points lower than it was in 1977.

Changes in the Distribution of Revenues by Source

Part of the change in total effective tax rates reflects changes in the relative importance of different federal taxes. Summary Figure 2

Summary Figure 2.
Share of Total Federal Revenues by Source, 1975-1990



SOURCE: Congressional Budget Office tax computations.

shows the distribution of federal tax revenues by source. Since the mid-1970s, the distribution has shifted in the direction of personal and social insurance taxes and away from taxes on business. In 1975, 44 percent of federal tax revenues were attributable to the individual income tax, 30 percent to social insurance payroll taxes, 15 percent to the corporate income tax, 6 percent to combined federal excise taxes, and the remainder to miscellaneous receipts.

By 1984, the percentage of revenues attributable to the individual income tax was 45 percent, only slightly higher than in 1975. The individual income tax share reached a peak of 48 percent in 1982 and 1983. The share of revenues from social insurance taxes rose sharply between 1975 and 1984, reaching 36 percent in that year. The share of revenues from the corporate income tax had fallen to 8.5 percent by 1984.

Because the individual income tax is the most progressive federal tax, while social insurance payroll taxes are, in general, much less progressive and even regressive in the highest-income range, the increased importance of social insurance taxes contributed to the decrease in the progressivity of total federal taxes between 1977 and 1984.

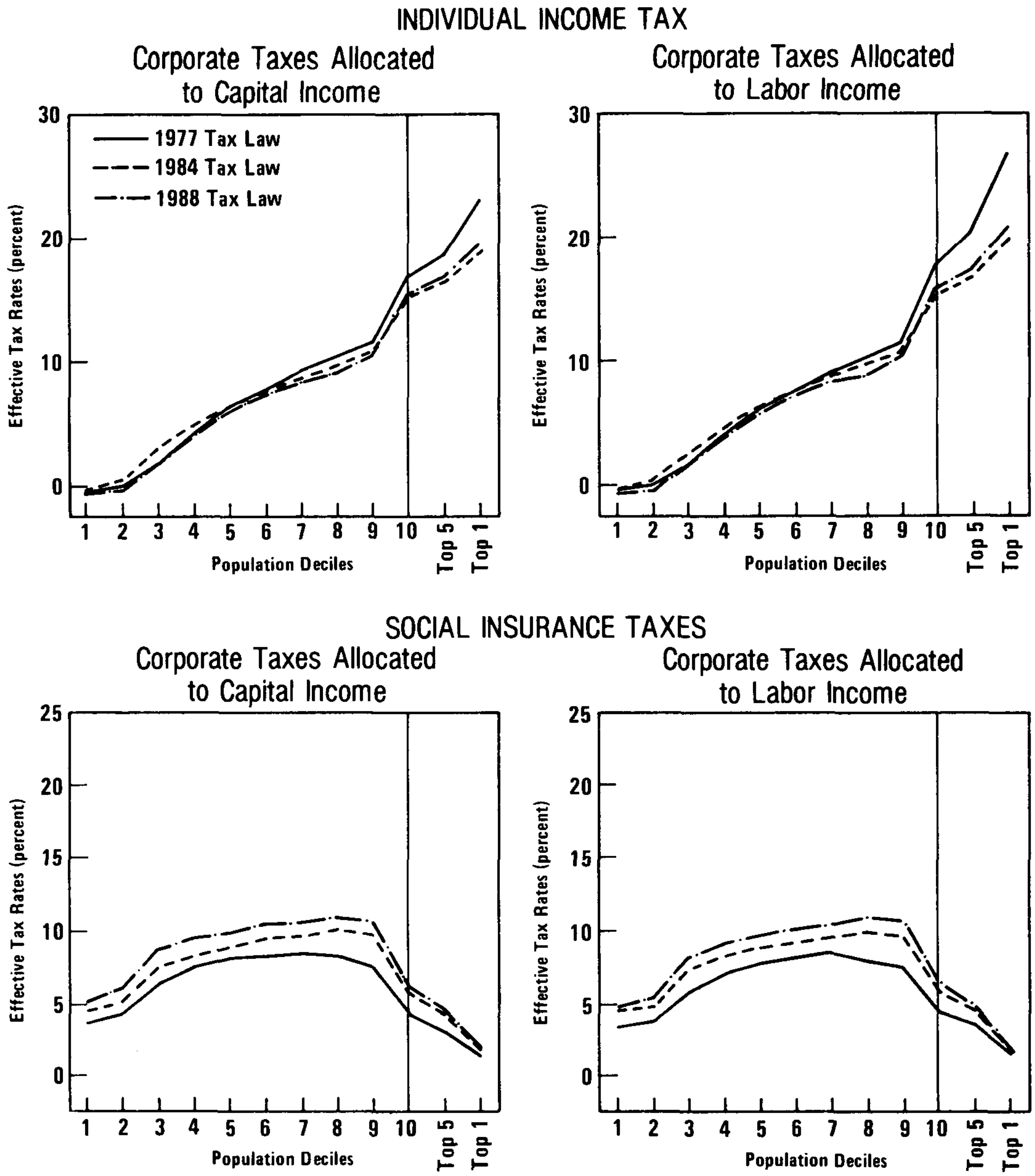
After falling slightly, the share of federal revenues from the individual income tax is projected to return to 45 percent of total federal revenues by 1990. The share of federal revenues from social insurance taxes is projected to rise slightly to 37 percent. The share from the corporate income tax is projected to rise to 12 percent.

Changes in Effective Tax Rates by Type of Tax

Another part of the change in total effective tax rates reflects changes in the effective tax rate for each of the different federal taxes. Summary Figure 3 shows the effective tax rate for individual income and social insurance taxes in 1977, 1984, and 1988. Because family income includes a family's share of the corporate income tax, these effective tax rates depend on the allocation of the corporate income tax. The differences are small enough, however, that for each tax the two distributions of effective tax rates look quite similar. Between 1977 and 1984, effective individual income tax rates rose for families in the bottom two-fifths of the income distribution and fell for families in the top two-fifths. The change in effective tax rates for the top

Summary Figure 3.

Effective Federal Tax Rates by Population Decile



SOURCE: Congressional Budget Office tax simulation models.

NOTE: Families are ranked by the size of family income. Because family income includes the family's share of the corporate income tax, the ordering of families depends on the allocation of corporate taxes. The lowest decile excludes families with zero or negative incomes.

The effective tax rate is the ratio of taxes to family income in each income class.

decile was the most dramatic, falling by about two percentage points. Between 1984 and 1988 the effective tax rate will fall for all deciles except the highest. Every income group will have the same or lower effective individual income tax rate in 1988 than in 1977, with the largest reductions for the higher-income groups.

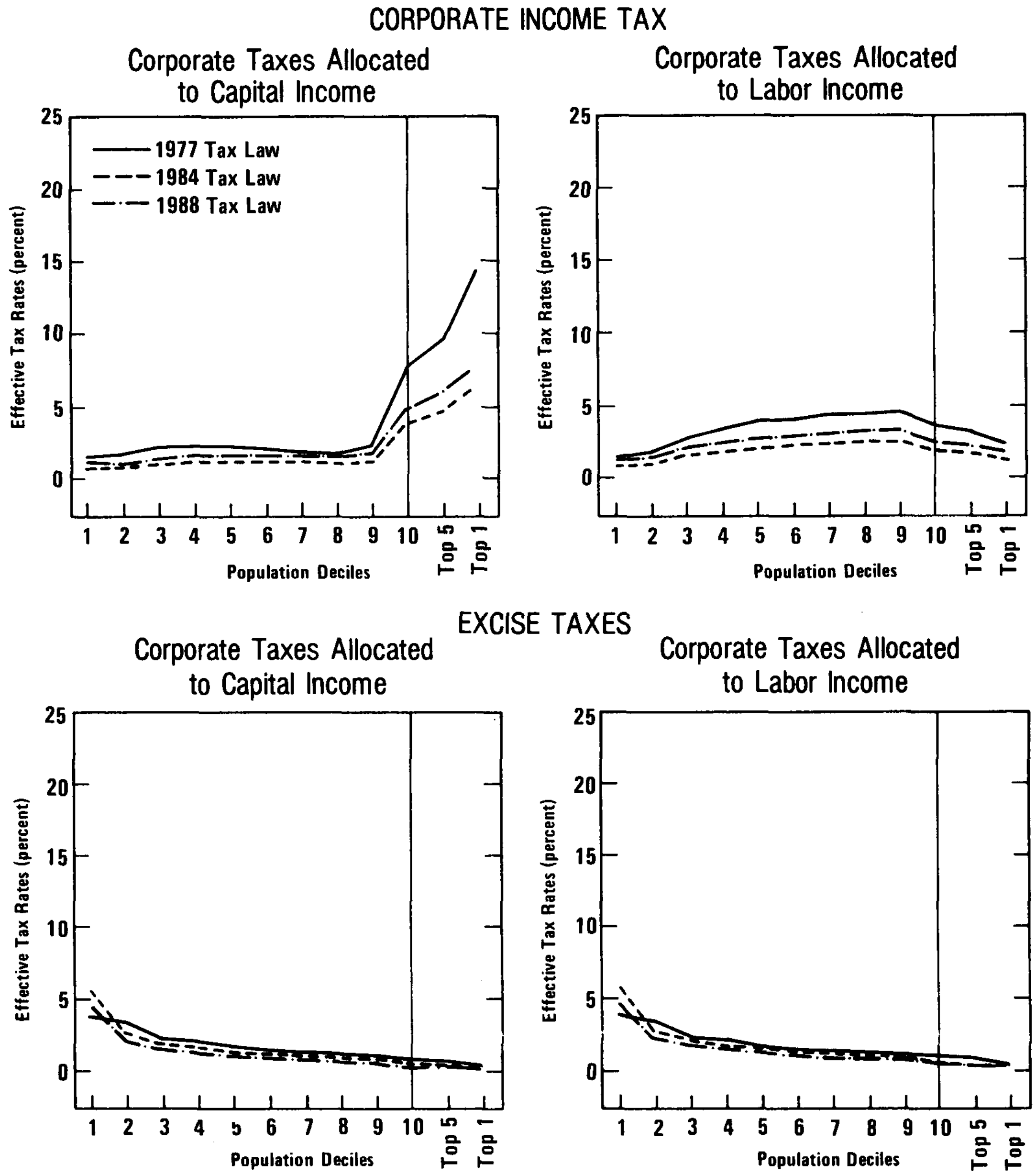
The effective social insurance tax rate will rise between 1977 and 1988 for every income group, reflecting the increase in the combined Social Security payroll tax rate from 11.70 percent to 15.02 percent. The effective social insurance tax rate increased faster between 1977 and 1984 for higher-income groups because the maximum amount of earnings subject to the tax rose nearly 40 percent faster than wages. By 1988, the effective social insurance rate will exceed the effective individual income tax rate for all but the highest decile.

The pattern of effective corporate income tax rates depends on the allocation of the corporate tax. Summary Figure 4 shows the distribution of effective corporate tax rates in 1977, 1984, and 1988 under both allocations of the tax. When the tax is allocated to capital incomes, the highest-income groups have much higher tax rates than the other income deciles. When the tax is allocated to labor income, the effective corporate tax rate is lower at the bottom and the top of the income distribution. This result occurs because with the allocation to labor incomes, the corporate tax is equivalent to a proportional tax on wages; and for families in the lowest- and highest-income groups, labor income is a smaller share of total income than for the average family. The level of effective corporate income tax rates is almost 50 percent lower in 1984 than in 1977, and is projected to be about 30 percent lower in 1988 than in 1977 (but higher than in 1984). The lower rate for 1984 reflects both a lower corporate profit share of GNP and a lower tax rate on corporate profits. The rate for 1988 reflects a continuation of a lower projected profit share, offset partially by legislation that raised effective rates on profits after 1984.

Summary Figure 4 also shows the effective excise tax rate. The effective excise tax rate declines with income in all three years. For all groups except the lowest, the effective excise tax rate is lower in 1984, and is projected to be lower in 1988, than it was in 1977. The increase in the gasoline excise tax and the drop in real income of the bottom decile are responsible for the increase in the effective tax rate for families in the lowest-income decile.

Summary Figure 4.

Effective Federal Tax Rates by Population Decile



SOURCE: Congressional Budget Office tax simulation models.

NOTE: Families are ranked by the size of family income. Because family income includes the family's share of the corporate income tax, the ordering of families depends on the allocation of corporate taxes. The lowest decile excludes families with zero or negative incomes.

The effective tax rate is the ratio of taxes to family income in each income class.

In this analysis, family income is measured over a single year. Income measured on an annual basis tends to understate the true economic circumstances of many of the lowest-income families. While most taxes are also based on annual incomes and thus reflect a family's current income status, excise taxes depend on family expenditures. Expenditures probably are related more closely to an expected long-term level of income than to income in a single year. Families whose incomes may have fallen temporarily are likely to maintain their previous level of expenditures in the expectation that their incomes will return to more normal levels. Young families may spend a large fraction of their current incomes, even greater than 100 percent, because they expect their incomes to rise significantly over time. Measuring the distribution of excise taxes over family income measured in a single year will tend to overstate the burden of those taxes on permanently low-income families. To the extent that expenditures reflect permanent incomes, the regressivity of federal excise taxes measured against permanent income is less than the conventional measures presented in this study.

HOW TAX LAW CHANGES AFFECTED THE DISTRIBUTION OF FEDERAL TAXES

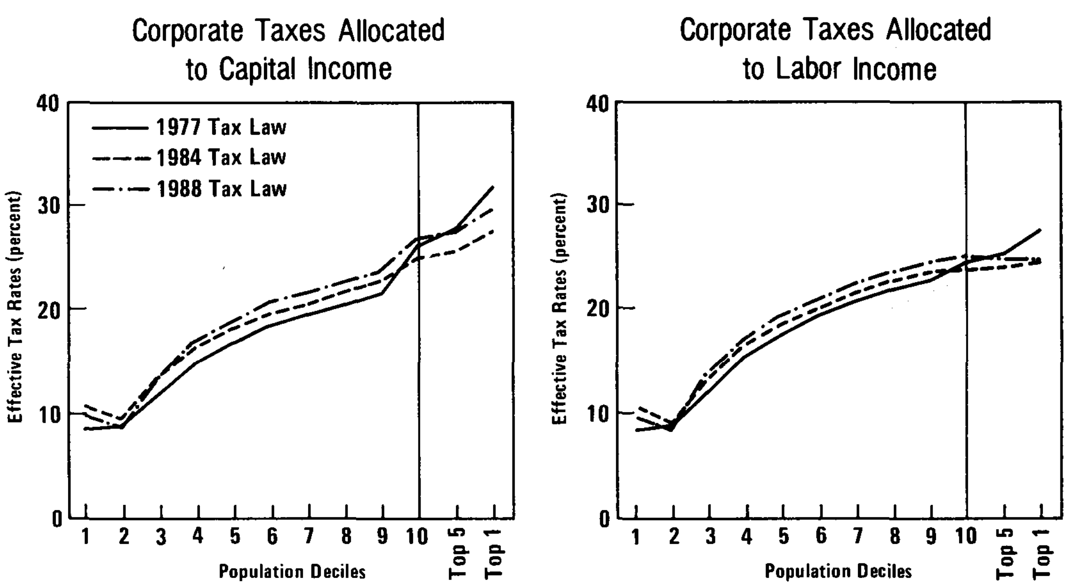
Changes in the distribution of tax liabilities over years are not the result solely of changes in the tax laws. The level and distribution of family income also change between years. The distribution of effective tax rates shifts between years for three reasons: changes in tax law change the relationship between income and taxes; changes in tax law cause families to alter their economic behavior, thereby changing the level and distribution of incomes; and incomes change for reasons independent of the tax law. Because it is difficult to distinguish accurately between changes in incomes caused by changes in the tax law and changes in incomes that occur for other reasons, the full effect of changes in the law on the distribution of tax liabilities is not readily measurable. By holding constant the level and distribution of income, however, it is possible to isolate the effect of changes in the law on the relationship between income and taxes.

In the study, the distributions of federal tax liabilities under 1977, 1984, and 1988 tax laws are also compared holding incomes constant at their 1984 and 1988 levels. The constant-income distributions of federal taxes show generally the same results as the comparisons across years, but with less dramatic differences between 1977 and the other years in the highest-income deciles. Summary Figure 5 compares total effective tax rates in 1988 under the 1988 tax law, and under the 1977 and 1984 tax laws adjusted to 1988 levels. The greater progressivity of the 1977 tax law is still apparent, but for the highest-income decile the differences between the 1977 law and the 1984 and 1988 laws are reduced. The results for the laws evaluated at 1984 incomes (not shown here) are quite similar.

For most deciles except the highest, total effective tax rates for the adjusted 1977 law in 1988 are lower than total effective tax rates for either the adjusted 1984 law or the 1988 law in 1988. The much more pronounced difference in effective tax rates over most of the income distribution in Summary Figure 5 as compared with Summary Figure 1 is attributable to the change in the corporate profit share of national income. Effective tax rates for individual income, Social Security payroll, and excise taxes are only slightly different for the same tax law evaluated at different income levels. But, for almost all deciles, effective corporate income tax rates for the 1977 law are much lower when the corporate profit share of gross national product is held constant at 1988 levels (as in Summary Figure 5) than with the 1977 profits share (as in Summary Figure 1).

Summary Figure 5.

Effective Federal Tax Rates by Population Decile, 1988, Under Tax Laws Adjusted to 1988 Incomes (All taxes combined)



SOURCE: Congressional Budget Office tax simulation models.

NOTE: Families are ranked by the size of family income. Because family income includes the family's share of the corporate income tax, the ordering of families depends on the allocation of corporate taxes. The lowest decile excludes families with zero or negative incomes.

CHAPTER I

INTRODUCTION

In the past decade, the Congress has enacted a series of significant changes in federal tax laws. These changes began with the Tax Reform Act of 1978 and included the Economic Recovery Tax Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, the Social Security Amendments of 1977 and 1983, and the Tax Reform Act of 1986--the latter being the first complete revision of the Internal Revenue Code since 1954. Over the same period, the level and distribution of incomes have also changed. The combination of changes in tax laws and changes in income (including the interaction of the two) have changed the distribution of federal tax liabilities.

This paper compares changes in the distribution of separate and combined federal tax burdens by family income classes over the period from 1975 through 1990.1/ The federal taxes included are individual and corporate income taxes, social insurance payroll taxes, and excise taxes. These taxes account for about 95 percent of total federal tax revenues. The remainder of federal revenues come from estate and gift taxes, customs duties, and miscellaneous receipts. Revenues from these remaining sources are not included in the analysis because of the difficulty of attributing these liabilities to particular families.

Changes in the distribution of tax liabilities across income groups are measured primarily by changes in the ratio of taxes to incomes (effective tax rates). A particular tax is characterized as progressive if

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1. Earlier studies of the distribution of tax burdens include: Joseph A. Pechman and Benjamin A. Okner, *Who Bears the Tax Burden?* (Washington, D.C.: The Brookings Institution, 1974); Richard A. Musgrave, Karl E. Case, and Herman Leonard, "The Distribution of Fiscal Burdens and Benefits," *Public Finance Quarterly*, vol. 2 (July 1974), pp. 259-311; Edgar K. Browning and William R. Johnson, *The Distribution of the Tax Burden* (Washington, D.C.: American Enterprise Institute, 1979); Morgan Reynolds and Eugene Smolensky, *Public Expenditures, Taxes and the Distribution of Income: The United States, 1950, 1961, 1970* (New York: Academic Press, 1977); and Joseph A. Pechman, *Who Paid the Taxes, 1966-85?* (Washington, D.C.: The Brookings Institution, 1985).

the ratio of taxes to incomes rises as income rises, regressive if the ratio of taxes to incomes falls as income rises, or proportional if the ratio is the same at all income levels.

The results of this analysis necessarily rely on assumptions that are subject to challenge. There is no definitive way in which to assign the burden of federal corporate income taxes, excise taxes, and the employer portion of payroll taxes to particular family income groups. Neither is there a definitive way to measure family incomes. Both require methodological judgments and compromises that bear critically upon the results obtained. While these judgments are made explicit, and alternative assumptions are used in allocating corporate income taxes, these are not the only possible approaches.

TOPICS NOT COVERED

This paper analyzes only changes in the relationship of tax liabilities to family incomes by family income classes. It does not consider changes in horizontal equity (that is, the treatment of families with equal incomes). Nor does it consider the effects on incentives of changes in the tax system and the resulting changes in the level and distribution of incomes. The results should therefore not be treated as a complete assessment of the effects of recent and continuing changes in federal tax laws.

Finally, the distributional effects of government expenditures are not taken into account. Certain federal expenditures, such as those for national defense, general government administration, and discretionary economic subsidies and social programs, cannot be allocated to particular families; yet they do not benefit all families equally. Some taxes are earmarked for special purposes. Certain excise taxes, such as the motor fuels tax on gasoline or the air passenger ticket tax, are dedicated to special trust funds. Monies from these funds are used for directly related expenditures such as highway and airport construction and maintenance. Social Security payroll taxes also are dedicated to special trust funds from which retirement, disability, and health insurance benefits are paid. Indeed, some analysts argue that a portion of Social Security contributions should properly not be treated as taxes but rather as government-sponsored savings.2/

The study does not attempt to allocate the distributional effects of either general government spending or spending from specially dedicated trust funds to particular family income classes. Thus, in comparing the distribution of taxes by family income classes across years, it ignores the possibility that the distribution of government expenditures may also have shifted between those years. In this context, Social Security is treated as a separable tax/transfer system with no direct link between current payroll taxes and future retirement benefits.

2. For a discussion of this issue, see Edgar K. Browning, "The Marginal Social Security Tax on Labor," *Public Finance Quarterly*, vol. 13, no. 3 (July 1985), pp. 227-252; and Richard V. Burkhauser and John A. Turner, "Is the Social Security Payroll Tax a Tax?" *Public Finance Quarterly*, vol. 13, no. 3 (July 1985), pp. 253-268.

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CHAPTER II

OVERVIEW OF FEDERAL REVENUES AND FEDERAL TAX LEGISLATION, 1975-1990

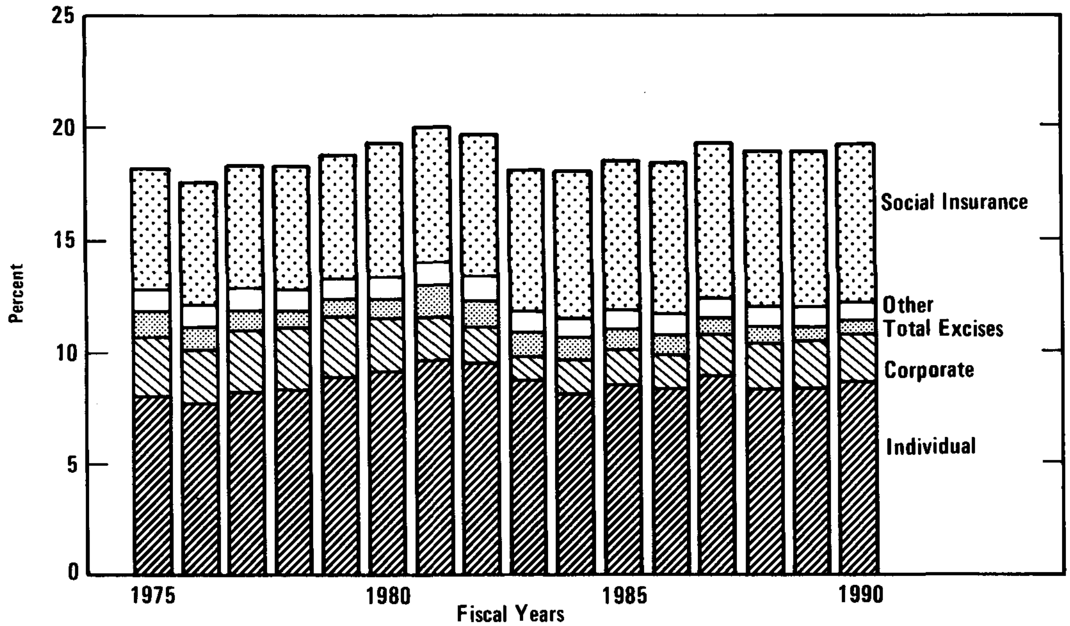
Numerous changes occurred in federal tax laws between 1975 and 1986. These changes, combined with changes in prices and in the level and composition of income, caused fluctuations in the level and composition of federal revenues. This chapter begins with a discussion of the composition of federal revenues and then examines each major source of revenue in turn.

THE LEVEL AND COMPOSITION OF FEDERAL REVENUES

Since the mid-1970s, the distribution of federal tax receipts by tax source has been marked by a shift in the direction of personal taxes and away from taxes on business. Over the 1975 to 1983 period, the individual income tax and social insurance taxes grew in relative importance as sources of federal revenues while the corporate income tax and federal excise taxes declined. Since 1983, the trend in individual and corporate income taxes has been partially reversed, but neither tax has returned to its 1975 share of total revenues. The relative importance of social insurance taxes has continued to grow. If there are no further changes in tax legislation, projections indicate that the relative importance of the individual income tax and social insurance taxes will stabilize at about their current levels. The importance of the corporate income tax will grow but will not return to its 1975 level by 1990, while the importance of excise taxes will decline.

The changing distribution of revenues by tax source reflects both changes in tax law and the effect of changing economic conditions. Figure 1 shows federal revenues from each tax source as a percent of gross national product (GNP). Revenues as a share of GNP rose from 17.6 percent in 1976 to a peak of 20.1 percent in 1981. Because of tax cutting legislation passed in 1981 and the recession that began in the fourth quarter of that year, the percentage dropped to 18.1 in 1983. Subsequent legislation and growth in real incomes will raise the per-

Figure 1.
Revenues by Source as Shares of GNP, 1975-1990



SOURCE: Congressional Budget Office tax computations.

centage to 19.3 in 1987. Revenues as a share of GNP are expected to remain at approximately that level through the remainder of the current decade.

Individual income tax revenues, which account for nearly half of total revenues, move in much the same pattern as total revenues. Individual income tax revenues as a share of GNP grew somewhat faster than the total revenue share of GNP from 1975 to 1981 and are forecast to fall slightly between 1987 and 1990. Corporate income tax revenues as a share of GNP dropped sharply from 1977 to 1983 but are expected to be twice as high in 1990 as in 1983, although still below their 1975 share. Social insurance revenues as a share of GNP will grow from 5.3 percent in 1976 to 7.0 percent in 1990.

THE INDIVIDUAL INCOME TAX

Individual income tax revenues as a share of GNP grew from 8 percent in 1975 to 9.6 in 1981. Much of this growth was the result of inflation-induced increases in individual income tax burdens. These increases were not offset until the enactment of the Economic Recovery Tax Act of 1981 (ERTA), which cut tax rates by 23 percent over a three-year period. ERTA also provided that tax brackets would be indexed for inflation beginning in 1985. As a result, individual income tax revenues remained at a relatively constant percent of GNP in 1985 and 1986, growing only as real incomes increased. Tax reductions enacted in the Tax Reform Act of 1986 are projected to lower individual income tax revenues as a share of GNP in 1988 below what they would have been under previous law. The ratio of individual income taxes to GNP will rise slightly through the remainder of the decade as real incomes continue to grow and some of the revenue-raising provisions of the 1986 Tax Act are phased in.

Changes in the individual income tax have affected not only the level of individual income taxes but also the distribution of taxes among families. Tax legislation can affect the distribution of the individual income tax in three primary areas-allowing or disallowing certain deductions from income, setting the level at which income becomes taxable, and specifying the tax rate schedule. Legislated changes in individual income tax laws from 1975 to 1985 served to narrow the tax base in ways particularly favorable to higher-income families. Changes *not* made in this inflationary period raised taxes for low-income families by allowing the income level at which families are subject to individual income taxes to fall relative to family incomes. The Tax Reform Act of 1986 will undo the changes in the tax base and will restore the tax-exempt level of income to inflation-adjusted 1975 levels.

Changes in the Tax Base

Until the Tax Reform Act of 1986, the major changes in the individual income tax base over the period involved the treatment of retirement income, special deductions for married couples in which both spouses work, and the treatment of capital gains. Legislation enacted in 1974, 1978, and 1981 served to narrow the tax base. The Pension Reform Act of 1974 allowed workers not covered by a private pension plan to contribute to tax-deferred individual retirement accounts (IRAs). The Economic Recovery Tax Act of 1981 (ERTA) substantially liberalized the deduction for IRAs by allowing all workers to set up an IRA and increasing the maximum amount of allowable contributions. ERTA also established a new deduction for married couples in which both spouses worked, allowing a 10 percent deduction, up to a maximum of

$3,000, against the earnings of the lower-earning spouse. The treatment of capital gains was liberalized by the 1978 Revenue Act, which increased the exclusion for long-term capital gains from 50 percent to 60 percent. The benefits of these particular deductions accrued disproportionately to higher income families.1/

All of these provisions were reversed by the Tax Reform Act of 1986, which eliminated the two-earner deduction, the IRA deduction for high-income taxpayers who are covered by private pensions, and the partial exclusion of long-term capital gains. The 1986 act also substantially restricted itemized deductions and limited the ability of taxpayers to offset their income with partnership and rental losses.

Changes in the Tax Threshold

A major factor in determining the tax burden on lower-income families is the income tax threshold--the level at which income becomes subject to tax. The level of tax-exempt income depends on the personal exemption amount, the number of exemptions, the standard deduction (or zero bracket amount), and certain personal tax credits. Table 1 shows how these elements of the tax code have changed and are expected to change. The Tax Reduction Act of 1975, which introduced the general tax credit and an earned income credit for low-income recipients, eliminated or lessened the tax burden for many low-income families. The Tax Reduction and Simplification Act of 1977 raised the low-income allowance and converted it into a zero bracket amount. The Revenue Act of 1978 eliminated the general tax credit but increased the personal exemption and the earned income credit, effective in 1979.

After 1979, no further increases were made in either the personal exemption amount or the standard deduction until 1985. This allowed the real value of exemptions and deductions to erode as prices rose. The earned income credit was not changed until the Deficit Reduction

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1. A 1986 Congressional Budget Office study, "The Effects of the 1981 Tax Act on the Distribution of Income and Taxes Paid," found that taxpayers in the top 25 percent of the income distribution (except for those in the top 1 percent) generally received a 7 percent to 8 percent reduction in tax liabilities from changes in the tax base, while the remaining 75 percent of taxpayers received a 2 percent to 3 percent reduction (p. 34).

Act of 1984 raised the maximum amount of the credit from $500 to $550 beginning in 1985.

The effect of these changes is illustrated in Figure 2. The figure shows the ratio of the income tax threshold to the poverty threshold for two types of families: a married couple with two children and a single head of household with two children. The poverty threshold is the Census Bureau's official measure of poverty-level income. The threshold varies by family size and is indexed to increases in consumer prices.

With no changes in the nominal tax-exempt level of income between 1979 and 1985, inflationary growth in family incomes caused the real value of the tax-exempt level of income to decline. In 1979, the tax-exempt level of income for a married couple with two children was equal to approximately 120 percent of the poverty threshold for a family of four. By 1984, the tax exempt level of income had fallen to

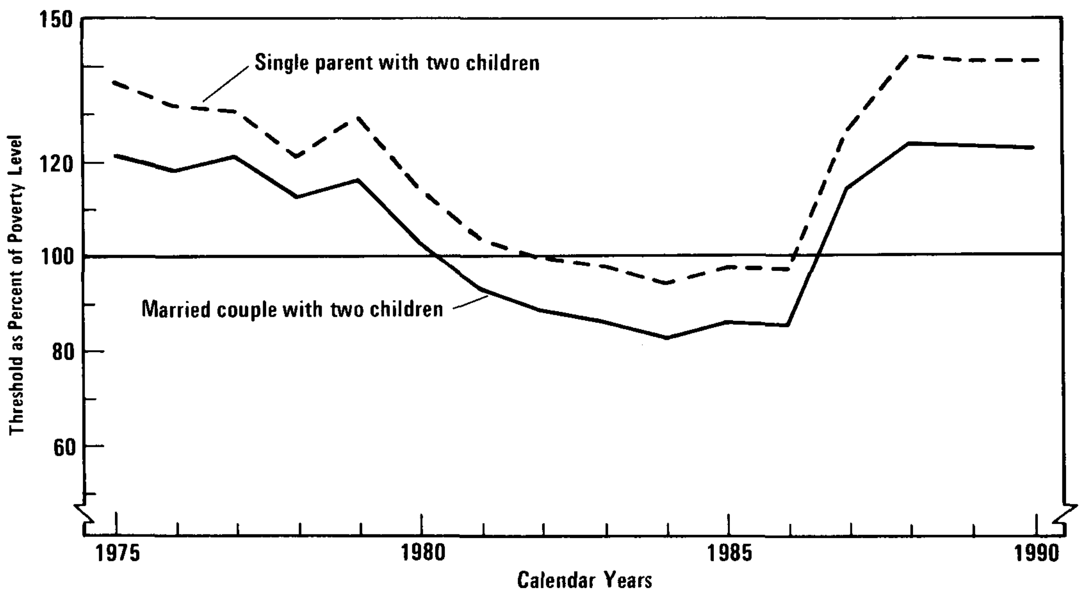
TABLE 1. EXEMPTIONS, STANDARD DEDUCTIONS, AND CREDITS FOR THE INDIVIDUAL INCOME TAX, 1975-1990
(By calendar year)

Year	Personal Exemption	Standard Deduction for Married Couples a/	Tax Credit per Exemption	Maximum Amount of Earned Income Credit
1975	750	1,900	30	400
1976	750	2,100	35	400
1977	750	3,200	35	400
1978	750	3,200	35	400
1979	1,000	3,400	0	500
1980	1,000	3,400	0	500
1981	1,000	3,400	0	500
1982	1,000	3,400	0	500
1983	1,000	3,400	0	500
1984	1,000	3,400	0	500
1985	1,040	3,540	0	550
1986	1,080	3,670	0	550
1987	1,900	3,760	0	850
1988	1,950	5,000	0	875
1989	2,000	5,250	0	920
1990	2,050	5,500	0	966

SOURCE: Internal Revenue Code and Congressional Budget Office projections.

a. Low-income allowance in 1975 and 1976; zero bracket amount in 1977 through 1986.

Figure 2.
Ratio of Income Tax Threshold to Poverty Level, 1975-1990



SOURCE: Congressional Budget Office tax computations.

NOTE: All income is assumed to be earnings. For the married couple, one spouse is assumed to have all of the earnings.

about 80 percent of the poverty threshold for the same type of family. The Economic Recovery Tax Act of 1981 provided for indexation of personal exemptions and the zero bracket amount (ZBA). However, because indexing did not take place until 1985, the real value of personal exemptions and the ZBA continued to decline until 1985. ERTA did not provide for indexing of the earned income credit.

The Tax Reform Act of 1986 raised the zero bracket amount, which was converted back into a standard deduction, and increased the personal exemption and the earned income credit. The 1986 act also provided for indexing of the earned income credit. Figure 2 shows that these changes are projected to raise the tax-exempt level of income to over 120 percent of the poverty threshold for a married couple with two children by 1988. Indexing of personal exemptions, the standard deduction, and the earned income credit will keep the tax-exempt level of income at the same position relative to the poverty line thereafter.

Changes in Tax Rates

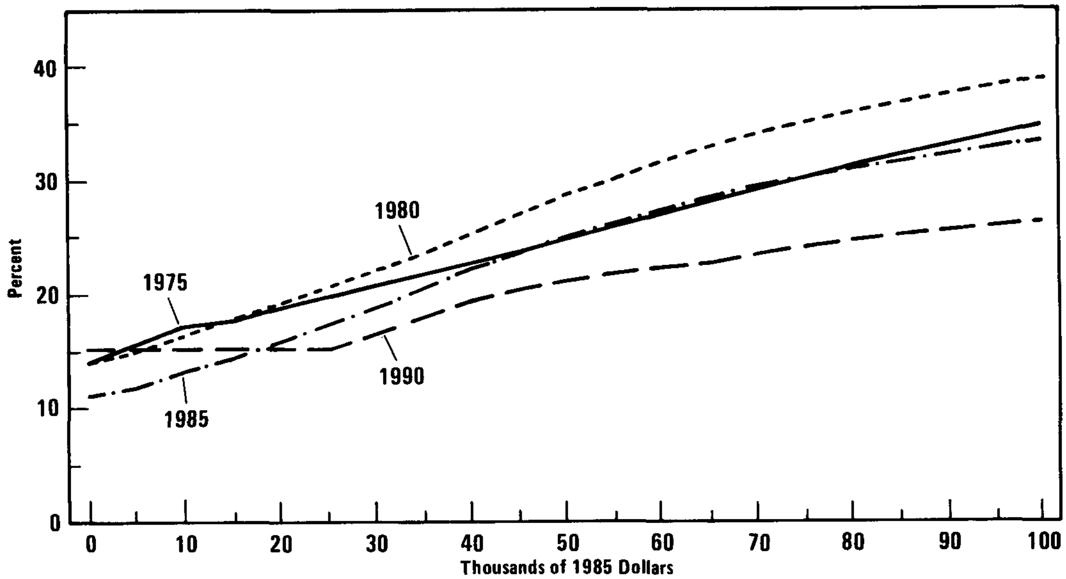
There also have been major changes in the individual income tax rate structure. The rate structure determines the tax liability for a given level of taxable income. In the Economic Recovery Tax Act of 1981, the Congress lowered the top marginal tax rate on individual income from 70 percent to 50 percent, and reduced other marginal tax rates by 23 percent over a three-year period. ERTA also provided for indexing the width of the tax brackets beginning in 1985.

The Tax Reform Act of 1986 replaced the previous multibracketed formula with a transitional five-bracket formula in 1987 and a two-bracket formula for all subsequent years. The 1986 act also lowered the maximum tax rate on individual income taxes to 28 percent. However, the law also contained a recapture provision for the benefits of lower rates on income in the bottom bracket, which will result in marginal tax rates of 33 percent over certain high-income ranges.

Figure 3 shows the ratio of computed taxes to taxable income at different levels of taxable income for a married couple with two children in selected years. Taxable income is in 1985 dollars in all years. Taxable income in Figure 3 refers to the tax concept of income after all adjustments, exemptions, and deductions.2/ Figure 3 illustrates the steepness of the individual income tax rate structure but does not by itself completely indicate the progressivity of the tax system in different years because the rules for computing taxable income changed substantially between years. The figure shows that families at most levels of real taxable income would have paid higher taxes in 1980 than in 1975. Except at the lowest levels of income, inflation between 1975 and 1980 more than offset a widening of the tax brackets in 1979, narrowing tax brackets in real terms and causing tax rates to rise faster with taxable income. The ERTA reduction in tax rates produced a downward shift in the tax schedule

2. To make taxable income comparable across years, taxable income in 1975 reflects the effect of the general tax credit on the income tax threshold. Also, 1980 and 1985 taxable incomes were reduced by the amount of the ZBA.

Figure 3.
Individual Income Tax as a Percent of Taxable Income
(For a married couple with two children)



SOURCE: Congressional Budget Office tax computations.

NOTE: Taxable income in 1975 reflects the general tax credit. Taxable income in 1980 and 1985 excludes the zero bracket amount.

between 1980 and 1985.3/ By 1990, the changes from the Tax Reform Act of 1986 will have reduced the steepness of the schedule.

SOCIAL INSURANCE TAXES

The continuing increase in social insurance taxes as a percentage of GNP reflects increases in Social Security payroll taxes enacted in the Social Security Amendments of 1973, 1977, and 1983. Social Security payroll taxes account for between 84 percent and 93 percent of all social insurance revenue collected over this period. Table 2 shows

3. Although ERTA reduced all but the highest marginal tax rate by the same percentage between 1981 and 1984, the figure shows reductions of about 20 percent for taxable incomes between $0 and $20,000 and from 13 percent to 14 percent for incomes of $30,000 and higher. Because ERTA did not change bracket widths until 1985, inflation narrowed the tax brackets, causing the same level of real income to be taxed in a higher income bracket in 1985 than in 1980.